

2017 Year in Review

Investment markets are a lot like the weather – you might expect one thing from the forecast, but you don't actually know what will happen until you move through it.

Have you ever carried your umbrella, certain of a downpour, and enjoyed only clear skies? Or purchased a new snow blower just before a winter of very little snowfall? Similar things happen in the investment market. Investors prepare for events that could happen, but then fail to appear. So ... is being prepared for an event that doesn't materialize silly, or is it prudent?

A year ago, as 2016 was coming to a close, there were a number of unexpected events. Donald Trump had just been elected president, the Federal Reserve had gone a full year without raising interest rates, and inflation hadn't increased as expected. Now we know that the extended stock valuations existing at the end of 2016 would become even more extended by the end of 2017.

Hits and Misses

With stock valuations at elevated levels at the start of the year, we looked to provide some defense in case of increased volatility by adding value stocks to portfolio allocations. Those value stocks trailed growth stocks throughout the year, so they fell short of adding value.

Likewise, we looked to an allocation in dividend-paying stocks to provide some cushion in the event of downward market pressure – pressure, as it turned out, that never developed. Mid- and small-cap stocks generally lagged their large-cap counterparts, so our mid- and small-cap allocations trailed those of large cap colleagues.

Our value-added allocations included positions in technology, growth-oriented active management and, to a lesser degree, financials. Our allocation to energy stocks toward the end of last January proved to be too early. Energy stocks underperformed the general market through mid-August, then became the best-performing sector – but not yet good enough to offset the timing of the earlier purchase.

While client account returns are all different, depending on cash flows, allocation and timing of trades, Bell's all-stock model looks like it had a return of about 18.44 percent for the year.

The Stock Market

Given the economic events and uncertainty that were in place at the beginning of the year, stock market returns in 2017 were a pleasant surprise.

Full Year 2017	
S&P 600 Growth	14.61%
S&P 600 Value	11.30%
S&P 500 Growth	27.22%
S&P 500 Value	15.12%
Russell 3000	20.91%
Equity Hedge Fund Index	9.98%

The S&P 500 was lopsided last year, with FAANG stocks (Facebook, Apple, Amazon, Netflix and Google (Alphabet)) making up a disproportionate share of returns. Combined with Microsoft and Nvidia, these stocks accounted for 29 percent of the S&P 500 returns, even though they compose only slightly more than 1 percent of the 504 stocks and 13 percent of the weighted allocation in the S&P 500.

Valuations are even higher today than they were at the end of 2016. The current P/E ratio of the S&P 500 is 22.7 compared to 20.57 in 2016. The price-to-sales ratio

of the S&P 500 finished 2017 at 2.24 times compared to 1.98 times the year before. It should also be noted that the recent high for the S&P 500's price-to-sales ratio was 2.25 times at the height of the tech stock bubble.

Since the recession ended in June 2009, the S&P 500 has risen 247 percent, or 15.76 percent annualized. Seeing those kinds of returns in that narrower timeframe makes many investors want to throw caution to the wind. But if the window of time is opened a few more years, going back to the start of the year 2000, the annualized return on the S&P 500 drops to 5.33 percent – very close to the Barclays Capital U.S. Government/Credit Bond Index return of 5.21 percent.

The Bond Market

Bond returns were also a pleasant surprise in 2017.

Full Year 2017	
Barclays Aggregate	3.54%
Barclays Int Govt/Cred	2.14%
Barclays 1-3 Mo Bill	0.82%
Barclays 5-10 Yr Treas	2.17%
Barclays 1-10 Yr Muni	3.03%

With interest rates and inflation predicted to rise, the bond market started the year facing the prospect of negative returns. We structured a portfolio allocation that aimed to generate cash flow consistent with higher-yielding, longer-term bonds, while keeping the duration shorter to protect some value in the event that interest rates did increase. It worked well. Bell's all-bond return looks like it had an average return of about 2.72 percent.

As the economy moved forward at a slow but steady pace in 2017, inflation and interest rates remained at the same comfortable levels as the last several years. This provided the framework for a quiet year in the bond markets, despite some predictions that Federal Reserve actions would be bad for bonds.

The Economy

Economic growth gained momentum in the second and third quarters, recording growth on a quarter-over-quarter basis of 3.1 and 3.2 percent respectively. Growth in the fourth quarter is also expected to be above 3 percent.

The unemployment rate continued to decline and currently stands at 4.3 percent. A level below 5 percent is considered to have an inflationary influence, but that did not materialize in a meaningful way. The annual inflation rate through the end of November was 2.2 percent, up from 1.7 percent the previous November. The Federal Reserve's preferred measure of inflation is personal consumption expenditure (the measure of consumer spending on goods and services). As of November, that rate was 1.5 percent, down from 1.81 percent a year earlier. Median wage growth reported by the Atlanta Fed is currently at 3.2 percent. So far, the low unemployment rate has not had a material impact on wage growth.

Consumer credit outstanding as of the end of October (the most recent data available) is \$3.8 trillion, compared to \$3.6 trillion the previous year. Consumer debt levels were cited as one of the reasons for the recession in 2008. At that time, consumer credit was \$2.7 trillion.

Leading economic indicators moved higher throughout 2017. The consumer confidence level is 8 percent higher than last year at this time. Housing remained on a stable growth path, with average home prices now exceeding the previous high recorded during the housing bubble.

The Federal Reserve

The Fed is in a tough spot. It has spent years adding liquidity in the form of quantitative easing programs, joined by central banks around the globe. This added significant amounts of liquidity, primarily directed toward investment markets and pushing stock and bond prices to record levels. Now the Fed is starting to increase interest rates and reverse quantitative easing programs. We expect the initial impact of the reversal to be limited as other central banks continue to opt for quantitative easing and tax reform spurs positive economic growth.

2018 Outlook

As 2018 kicks off, several economic issues could affect the markets – everything from central banks' actions to North Korea's unpredictable leader to Bitcoin and the other cryptocurrencies you may have read about in the news lately. Let's take a look briefly at our "top 10" potential impacts:

1. Prospects for more Fed rate increases or actions by global central banks

We anticipate the U.S. economy will grow around 3 percent in 2018. This may seem a bit low with the passage of the tax reform bill, but we are blending the tax bill impact with continued Fed activity, including increasing interest rates and removing monetary stimulus. We'll continue to watch the pace at which monetary policy is removed, combined with any spark in activity from the tax reform bill.

2. Extended stock market valuations in relation to historical averages

Extended stock market valuations suggest that equity returns will be more muted than in the recent past. Yes, we said this last year, and it didn't happen. At the very least, we anticipate more volatility in the investment markets this year compared to last year.

3. Potential for rising interest rates

We expect to see good economic growth news in the first half of the year, leading the Federal Reserve to raise short-term rates, which we feel will resonate through the rest of the bond market. With the slope of the yield curve remaining constant, any Fed increase will push longer-term interest rates higher, too. We project the 10-year U.S. Treasury bond to trade at a yield below 3 percent most of the year.

4. Potential for rising inflation

The call for rising inflation remains a common theme in the markets. We don't anticipate much upward pressure on a year-over-year basis in the first quarter. The inflation rate could pick up in the second quarter and then settle in for the final half of the year, finishing around 2.6 percent compared to 2.2 percent today. The recent "bomb cyclone" weather (vs. last year's "polar vortex") in the northeast could disrupt this forecast, as elevated energy prices hit inflation calculations earlier than expected.

5. Economic impact of the tax reform package

Our read is that the tax bill will benefit the average taxpayer who uses the standardized deduction option, resulting in positive economic growth. Contrary to many news reports, last year, total corporate taxes accounted for 11 percent of taxes collected, as shown on the U.S. Department of the Treasury website. As corporate tax savings are reinvested, economic growth is expected to follow.

6. Prospects for continued, synchronized global growth

Global growth around 3.5 percent is expected to exceed the U.S. growth rate. China is a big contributor to this number. China's gross domestic product (GDP) continues to grow. When you hear that China's growth decelerated from 6 percent to 5.5 percent, remember that the numerator (growth in GDP) is divided by the denominator (total GDP). You may see a declining growth "rate," but make no mistake – the overall "level" is rising. The prospect of synchronized global growth is probably the largest fundamental theme for the market.

7. Geopolitical conditions, including North Korea

North Korea is a wild card. Maybe China pressures the North Koreans to give up their nuclear aspirations. Maybe the North Koreans continue to agitate the situation. Maybe one of their test missile flights over Japan goes horribly wrong, falls from the sky and creates an international incident. Maybe Kim Jong-Un self-destructs. The market has been conditioned to ignore the actions of North Korea, but events could change this in a hurry.

8. Increasing cyberattacks

Last year Equifax reported that information on 150 million people was compromised by a cyberattack. The danger here is in increasing cyberattacks, any of which could shut down something like Amazon, a key financial player or part of the energy grid. Any type of chaotic event could end up moving the markets.

9. Elevated consumer credit and its impact on spending

Consumer credit outstanding is at record highs. Maybe the economic expansion, higher employment, low interest rates and now the tax bill support this elevated level of debt, but it sure looks like credit expansion will not be one of the drivers of economic growth in the near term.

10. Cryptocurrency (such as Bitcoin)

How does cryptocurrency make this list? Cryptocurrency is digital money used to transact commerce without intermediate processing or accounting via a bank or credit card company – instead processing through a series of computers networked via "blockchain" technology to independently verify the transaction and record the resulting balances. In addition to the cumbersome length of verification (7 to 10 minutes), a huge challenge of cryptocurrency is that the various currencies (of which Bitcoin is only one) are not the same as dollars. In our view, values of cryptocurrency are hugely inflated – but who can say what the value even is?

While blockchain may be the "next big thing" for financial companies, the greatest risk of cryptocurrency to the markets is how many people are wrapped up in the price appreciation of these cryptocurrencies as "investments." There is actually nothing investment-related about them – no earnings, no balance sheet, no underlying asset, no stability or consistency. In the end, my concern is that cryptocurrencies could fall in value. That would wipe out a lot of confidence and dreams which would (wrongly) be associated with our true investment markets.

Here's a real irony: the Washington Post recently ran an advertisement for a huge conference all about cryptocurrency. Mind you, you can't pay for the conference registration ... or your hotel ... or your meals ... in cryptocurrency. You need to pay in dollars, as usual.

To wrap things up ...

We expect to see moderate U.S. economic growth, elevated stock market valuations, some challenges in the fixed income markets, stable housing markets, reasonable commodity markets, synchronized global growth, the Fed successfully executing its monetary policy plan, and the positive effects of the tax bill working into the economy. If we had to put numbers on these expectations, we would say the stock market will rise 6 to 9 percent by the end of the year, with better than 50 percent odds of a 10 percent selloff at some point during the next 12 months. We look to bond returns to be between 0 and 2.5 percent for the year and inflation to remain mostly tame.

Stocks have a history of being more volatile than bonds. It is easy to forget that periods of great stock returns are needed to offset great losses that occurred at a different time. As stewards of our clients' investment dollars, we understand this and aim to diversify portfolios over the time horizon of each client's investment objective in an effort to generate attractive return and lower risk. Just as one index return differs from another, client returns differ compared to various indexes. Index returns are sometimes used as a way of determining if a portfolio return "won" or "lost." Very few investors devote all of their assets to a single index, which makes a comparison more a matter of curiosity than a basis in fact. Rather, indexes are a way of communicating what is happening in different areas of the market. Today, there are more indexes than there are stocks in the U.S., suggesting there is a lot of overlap in the stock holdings of the indexes, leaving some index conclusions open to interpretation.

We appreciate your business and confidence in Bell Bank.



Greg Sweeney, CFA,
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Tenure: 9/92

Years of Investment Experience: 32 years

Education: Greg holds a bachelor's degree in business from the University of North Dakota and is a CFA charter holder.